

STATEMENT OF

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on

THE FAILURE OF SUPERIOR BANK, FSB

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

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Mr. Chairman, Senator Gramm, and Members of the Committee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation regarding the failure of Superior Bank FSB, Hinsdale, Illinois (Superior). In my testimony today, I will briefly summarize the crucial issues, which make the failure of Superior of special interest to the regulators, the Congress and the public. I will provide a brief chronology of the FDIC's role in the events leading up to the failure of Superior followed by a description of our actions in resolving this troubled thrift. Finally, I will turn to a discussion of the lessons learned.

The primary reason for Superior's failure was the decision of its board and management to book high levels of retained interests related to the securitization of subprime assets. The retained interests were deeply subordinated, at a first loss position, to more senior claims on the more than \$4 billion in subprime loans that Superior sold to investors. Over the course of several years, Superior's retained interests represented an increasing multiple of its Tier 1 capital.

Volatility of Retained Interests

Since 1998, failures of institutions with risk characteristics similar to those of Superior have cost the FDIC insurance funds more than \$1 billion. The failure of Superior again highlights the inherent volatility of retained interests.¹ Retained interests, sometimes referred to as "residuals," represent an accounting recognition of immediate

gains on the sale of assets in the course of securitization activities. These interests pose significant valuation and liquidity concerns, particularly when related to higher-risk subprime or high loan-to-value loans. A complex, assumption-driven valuation process makes the value of the retained interest very volatile and subject to much interpretation.

Limits of Prompt Corrective Action

The failure of Superior also illustrates the limits of Prompt Corrective Action (PCA)—tools given to the regulators in 1991 to assist in the supervision of insured institutions and to assist in avoiding high costs to the insurance funds when institutions do fail. Although it has yet to be tested during a prolonged economic downturn, so far PCA has been successful and has worked in a high percentage of cases involving problem institutions. In fact, most troubled institutions turn around during the PCA supervisory process. However, the corrective actions under PCA will not necessarily stem the losses in situations where unrecognized losses are already embedded in the assets. This is especially true in situations such as the failure of Keystone National Bank, which involved fraud, and Superior, which involved a dramatic restatement of the complex, assumption-driven values related to retained interests.

Failures caused by fraudulent activity by bank managers or directors also pose a challenge to regulators and the implementation of PCA. From a supervisory standpoint, fraudulent activity is by its nature harder to detect than is conduct that is unsafe or unwise. Because fraud is both purposeful and harder to detect, it can -- and frequently

¹ Retained interests are balance sheet assets representing the right to a specified portion of the remaining cash flows from a securitization after paying bondholder obligations, covering credit losses, and paying

does -- significantly raise the cost of a bank failure. The same internal weaknesses that lead to credit and other operating losses have provided opportunities for dishonest and illegal activities.

Finally, the failure of Superior highlights the role of the institution's accountants when their opinions are at odds with the regulators. Going forward, this is a serious public policy issue that must be addressed.

As discussed in detail later in this testimony, the FDIC believes the banking agencies need to continue work towards ensuring that adequate risk-based capital is held against retained interest assets as well as implementing limits on the degree to which retained interests can be recognized for regulatory capital purposes.

FDIC'S ROLE IN THE EVENTS LEADING TO THE FAILURE OF SUPERIOR BANK

The Pritzker and Dworman families purchased Superior Bank in 1988 in a Federal Savings & Loan Insurance Corporation (FSLIC)- assisted transaction. At the time, the thrift was troubled and the investors injected \$42.5 million into Superior through a holding company, Coast-to-Coast Financial Corporation (CCFC). CCFC, in turn, owned Superior FSB through a shell holding company, Superior Holdings, Inc. (SHI), which was formed in 1998 and became a thrift holding company in 1999. CCFC itself was

servicing and trust-related fees.

owned by a multi-tiered and complex set of companies/trusts that is controlled by the Pritzkers and Dwormans.

During the late 1980's and early 1990's the thrift operated under an assistance agreement with the FSLIC.² The FDIC examined the troubled thrift several times during this period, usually concurrently with the Office of Thrift Supervision (OTS)—Superior's primary federal regulator. Superior's supervisory rating was eventually upgraded to a CAMEL rating of composite "2" in 1993 when the institution's condition stabilized.³ From 1993 to 1996, the thrift was rated a composite "2" by the OTS. In October 1997, the OTS assigned a composite "1" rating. During this period of time, based on the apparently satisfactory condition of the thrift, the FDIC's review of the thrift's financial condition was primarily limited to offsite monitoring of publicly available quarterly statements of income and condition filed with federal regulators, OTS examination reports, and other available information.

The FDIC's interest as insurer was heightened in December 1998 when we conducted an offsite review of Superior, based on September 30, 1998 financial information. The FDIC's offsite review noted significant reporting differences between the bank's audit report and its quarterly financial statement to regulators, increasing

² This agreement included capital protection provisions and called for reimbursement of expenses for collecting certain problem assets, payment of 22.5 percent of pre-tax net income to the FSLIC, and payment of a portion of certain recoveries to the FSLIC. (In later years, there was a disagreement over certain provisions to the assistance agreement and lawsuits are currently pending.)

³ CAMEL is an acronym for component ratings assigned in a bank examination: Capital, Asset quality, Management, Earnings, and Liquidity. In 1997, an additional component, "S" for Sensitivity to market risk, was added. A composite CAMELS rating combines these component ratings, again with 1 being the best rating.

levels of high-risk, subprime assets, and growth in retained interests and mortgage servicing assets. Based on these concerns, the FDIC sent a written request that an FDIC examiner participate in the January 1999 OTS examination. OTS orally denied this request but did share work papers and met with the FDIC at the end of the 1999 examination to discuss the bank's condition.

The FDIC's review of the OTS' January 1999 examination and additional offsite monitoring generated significant concerns about the institution's risk profile, particularly with regard to unusual regulatory reporting, and the high, and growing, concentration in retained interests and other high risk assets. As a result of our concerns, the FDIC officially downgraded the thrift to a composite "3" in May 1999, triggering deposit insurance payments under the risk related premium system. (OTS had downgraded the institution to a composite "2" after the 1999 exam.)

In September 1999, the OTS concurred with a formal FDIC request to participate in the January 2000 examination. Findings from this examination revealed many weaknesses, including extremely high concentrations of high-risk assets, inadequate management and controls, inaccurate reporting, and lack of documentation/support for retained interest valuations. The OTS and FDIC both assigned composite "4" ratings for the thrift in May 2000.

As the primary Federal regulator for this institution, the OTS issued a safety and soundness plan as a corrective action that, among other things, required the thrift to get an independent valuation of the retained interests, which was ultimately performed by

Ernst & Young (“E&Y”). FDIC and OTS examiners extensively reviewed the valuation and discussed it with thrift management and E&Y. In early August 2000, the FDIC noted that estimated future cash flows were not discounted to present value for some retained interests, which had the potential of significantly overstating the value of the retained interests. In late August 2000, the FDIC and OTS raised the issue with E&Y, who agreed to revisit the issue as part of their upcoming audit of Superior’s June 2000 fiscal year-end financial statements.

FDIC then participated in an OTS visit to Superior in October 2000 to review this issue, among other things. From this point until mid-December, in various correspondence, the local E&Y office attempted to support its position that the future estimated cash flows should not be discounted. OTS and FDIC objected, and in late December, the OTS directed the thrift to raise the issue to E&Y’s national office.

In mid-January, 2001, E&Y’s national partner agreed with the regulators, and the thrift began the process of revaluing the assets. Examiner estimates showed that the revaluation would result in significant writedowns and, in mid-February the OTS issued a Prompt Corrective Action (PCA) Significantly Undercapitalized notice to the thrift and Cease and Desist Orders to several of the holding companies.

On March 2, 2001, the thrift amended its financial statements, taking a \$270 million (gross) writedown on its books, reducing the capital ratio to 2.08 percent and book capital from approximately \$250 million to \$43 million. At this point, the FDIC

downgraded the thrift to a composite “5”. An OTS examination, with FDIC participation, began on March 19, 2001.

The thrift submitted its first PCA capital plan in mid-March, and a number of discussions were held between the regulators and with the thrift’s owners and management to address inadequacies in the plan. Various revisions were made to the plan over the next two months, with a modified plan received on May 18, 2001. During this time period FDIC raised a number of concerns about the plan with OTS both orally and in writing.

The proposals were very complex, but essentially provided for the sale of the thrift's retained interest portfolio to an entity to be owned, but not controlled by the Pritzkers (known as "Newco"). On May 24, the OTS approved the final capitalization plan. The FDIC had made a number of comments about the plan but ultimately did not object. At the time of OTS’s approval, we believed that the plan, which called for a \$270 million cash infusion, increased the chances for the thrift to become viable. It appeared that the bank would have an opportunity to begin to stabilize if the capital plan was implemented as presented. Also, all parties understood that cost cutting and shrinkage, and perhaps additional capital and strategic alliances would be necessary in the long run to ensure the thrift’s viability.

During the next two months, the FDIC and the OTS remained on site at Superior while the thrift’s owners and management began implementing the plan. Among other things, the owners began to negotiate the loan agreement called for by the plan, develop

required accounting and legal opinions, shed businesses, and cut costs. However, in mid to late July, the Pritzker family began indicating its reluctance to implement the plan as their and Dworman's proposed capital contributions appeared to be at greater risk. At that time, there had been marked deterioration in the loans underlying the retained interests, according to thrift representation. Also, the proposed lender had prepared a projection that showed cash flows could be less than those projected by the thrift's management. Numerous meetings were held with the OTS, thrift management, and the Pritzkers and Dwormans to discuss the issue.

Ultimately, the Pritzkers and Dwormans failed to implement the capital plan. On July 25, 2001, the FDIC Board met to consider Superior and met again on July 27, 2001, when the OTS closed the thrift and appointed the FDIC as receiver.

RESOLUTION OF THE SUPERIOR BANK FAILURE

When the FDIC took responsibility for Superior, the first priority was to provide virtually uninterrupted service for insured depositors. The FDIC transferred all the assets and insured deposits to New Superior, a newly chartered, full-service mutual savings bank under FDIC conservatorship. All insured depositors and customers automatically became customers of New Superior and depositors continued to have access to their funds by writing checks, using debit cards, going to New Superior's Internet site, and using automated teller machines.

Deposits — Insured and Uninsured

At the time of closing, Superior had approximately \$1.7 billion in over 91,000 deposit accounts. Of this, approximately 94 percent of the accounts totaling \$1.4 billion were initially determined to be fully insured and transferred to New Superior. Depositors had full access to these funds when the branches reopened Monday morning. The remaining 6 percent of the accounts, totaling approximately \$280 million, were considered potentially uninsured funds that required further FDIC review. To address the concerns of potential uninsured depositors and other customers, the FDIC immediately set up toll-free call centers, which handled over 8,700 customer inquiries during the closing weekend and over 48,000 customer inquiries through August 31. For those callers who had questions about deposit insurance coverage, appointments were scheduled with FDIC staff members. Through August 31, the FDIC has determined that an additional \$165 million of the \$280 million in deposits is insured and these funds have been released to depositors. Three percent of the \$1.7 billion in total deposits have been determined to be uninsured — a total of \$49 million. The FDIC is still gathering information from depositors to review insurance coverage for an additional \$68 million in deposits to determine if those deposits may be insured. The FDIC continues to work with depositors to resolve the remaining claims and ensure that insured depositors are protected.

Resolution Strategy and Management

The FDIC's strong preference in resolving a bank failure is to market the bank prior to the FDIC's appointment as receiver. This type of transaction allows us to minimize disruption to the failed bank's insured depositors and customers, while

minimizing the cost of failure to the deposit insurance funds. When Superior failed, however, the FDIC had not had an opportunity to effectively market the bank or its assets. After reviewing the alternatives, the FDIC Board of Directors determined that a conservatorship would be the least-cost alternative to the Savings Association Insurance Fund (SAIF), while maintaining banking services in the communities served by Superior. Unlike liquidation or other alternatives, the conservatorship allows the FDIC to market New Superior as a going concern and to attempt to sustain the ongoing value of the thrift's business. The FDIC Board believed that this was crucial to maximizing the sale price for the deposit franchise, the loan origination network, the loan servicing operation, and the residual interests and related servicing.

An important component of this strategy is effective management of New Superior. The FDIC has been able to obtain the services of an experienced banker, John D. Broderick, to serve as New Superior's Chief Executive Officer and President. The FDIC also created a five-person Board of Directors to oversee New Superior's operations during the conservatorship. The primary goal of Mr. Broderick and New Superior's Board is to prepare the institution for a return to the private sector in the near future.

The effectiveness of the conservatorship strategy requires that New Superior continue to be a full service bank. Accordingly, New Superior is continuing to accept deposits and make loans. To support operations, the FDIC has made available a \$1.5 billion line of credit. Through August 31, New Superior had drawn down \$644 million to maintain an appropriate liquidity cushion and finance operations. We anticipate substantial repayments to the line of credit as operations continue.

Alliance Funding, a division of Superior headquartered in Orangeburg, New York, continues to direct New Superior's consumer finance and mortgage banking operations. The FDIC has retained HanoverTrade.com, a subsidiary of Hanover Capital Mortgage Holdings, as a financial advisor to assist in the valuation and marketing of Alliance-related assets.

The FDIC is working with the staff of New Superior to return the institution to private ownership as soon as possible. The FDIC plans to start contacting potential bidders this month and expects to begin returning the deposits and assets to the private sector in October with completion by year-end. We will have a better estimate of the cost to the SAIF upon the final resolution of the conservatorship.

LESSONS FOR BANK MANAGEMENT AND BANK REGULATORS

The Offices of the Inspector General of the Department of Treasury and the FDIC and the General Accounting Office are all conducting reviews, and may have recommendations for the FDIC and OTS. However, certain lessons can already be drawn from the Superior failure and the failure of several other institutions in the past few years.

Subprime Lending and Securitization Remain a Concern

Concentrations in retained interests related to subprime assets figured prominently in at least two bank failures prior to the Superior failure, Keystone National Bank and Pacific Thrift and Loan (PTL). The FDIC has addressed these activities in various forms.

We have developed risk-focused examination procedures for evaluating subprime lending programs and securitization activities. The FDIC also closely monitors, on a quarterly basis, all insured institutions having 25 percent or more of Tier 1 Capital invested in subprime loans, high loan-to-value mortgages, and/or retained interests in securitizations. Effective June 30, 2001, the FDIC, OCC, and Federal Reserve implemented a new Call Report schedule that significantly increases our ability to monitor retained interests on an offsite basis.

Subprime Lending

Since 1997, the FDIC and the other federal banking regulators have been warning the industry about the increased risks in subprime lending through various formal communications and during on-site examinations. Subprime lending can meet the credit needs of a broad spectrum of borrowers in a safe and sound manner if: (1) risks are effectively managed through proper underwriting standards and attention to servicing; (2) loans are priced on the basis of risk; (3) allowances for loan losses cover the potential credit losses in the portfolios; and (4) capital levels reflect the additional risks inherent in this activity.

However, in some cases, these safeguards are not always maintained. The FDIC estimates that approximately 140 insured institutions have significant exposures in the subprime lending business. These subprime lenders represent just over one percent of all insured institutions, yet they account for nearly 20 percent of all problem institutions -- those with CAMELS ratings of "4" or "5". Ninety-five percent of all insured institutions

are rated CAMELS "1" or "2", while only 70 percent of the identified subprime lenders are so rated.

While not necessarily the proximate cause of the failure, 8 of the 22 banks that have failed since 1997 had significant subprime lending portfolios. Further, since most subprime lenders in the bank and thrift industry have not been tested in a prolonged economic downturn, it is realistic to expect additional problems for institutions with concentrations of subprime loans should economic conditions deteriorate further.

Securitization of Subprime Loans

A common theme emerging from our supervision of subprime lending is the uncertainty regarding the valuation and accounting for retained interests. In a securitization, the subprime lender sells packages of loans to another party or institution, but often retains as an asset the right to receive a portion of the cash flows expected from the loans. The expected value of these cash flows is generally referred to as the retained interest. A number of assumptions are involved in estimating the value of these retained interests, including default rates, loss severity factors, prepayment rates, and discount rates. Varying legal structures of securitizations and the number of factors that underlie the various assumptions further complicates the process.⁴

Under Generally Accepted Accounting Principles (GAAP), the fair value of these expected future cash flows are recorded on balance sheets as assets in the form of

⁴ For example, interest rates, economic conditions, loan terms, and loan underwriting, among other things, drive prepayment rates.

interest-only strips receivable, spread accounts, or other rights, sometimes referred to as retained interests. The best evidence of fair value is a quoted market price in an active market. However, in the case of retained interests where there is no market price, the value must be estimated based on the assumptions mentioned above. These assumptions need to be regularly analyzed and adjusted for current conditions.

Even when initial internal valuations are reasonable, unforeseen market events that affect default, payment, and discount rates can dramatically change the fair value of the asset. These complications sometimes lead to differences of opinion between examiners and banks and their accountants regarding the accounting and valuation of these assets. In the Keystone, Pacific Thrift & Loan, and Superior cases, the accountants, all nationally recognized firms, did not initially agree with examiners, resulting in protracted valuation and examination processes.

The banking agencies issued supervisory guidance concerning retained interests to banks on December 13, 1999. That guidance requires bank management, under the direction of its board of directors, to develop and implement policies that limit the type and amount of retained interests that may be booked as an asset and count toward equity capital. This interagency guidance also states that any securitization-related retained interest must be supported by objectively verifiable documentation of the interest's fair market value, utilizing reasonable, conservative valuation assumptions.

More Stringent Capital Standards Are Warranted

The banking regulators recognize the need to strengthen the capital requirement for retained interests. Retained interests serve as credit enhancements for the securitized assets. As such, these assets are considered to be recourse exposures that subject the institution to risk of loss on the transferred assets. As a result, under the current rules, risk-based capital is required for the securitized assets that are deemed to be transferred with recourse due to the retention of these retained interests.

The banking agencies' capital rules limit the amount of risk based capital that a bank or thrift must hold against retained interests, as well as other recourse exposures, to no more than the amount the institution would have been required to hold against the assets sold, had those assets remained on the bank's books—typically 8 percent of the amount of the assets sold for 100 percent risk-weighted assets. This amount is known as the “full capital charge.” The following illustration will clarify this concept:

An institution has \$100 in loans or other assets on its books that require a minimum of \$8 in total risk-based capital. The institution sells \$100 in assets, but retains a \$15 recourse exposure in the form of a retained interest. Under the current capital rules, the amount of risk based capital required would be \$8, even though the bank's exposure to loss is \$15. In the event the retained interest needed to be written down, the capital held against this asset may prove to be inadequate, which could pose undue risk to the bank.

On September 27, 2000, the agencies published a notice of proposed rulemaking entitled, “*Capital Maintenance: Residual Interests in Asset Securitization or Other Transfers of Financial Assets.*” This proposal is intended to address the concerns associated with retained interests. Retained interests have exposed some institutions to high levels of credit and liquidity risk, and their values have proven to be quite volatile. The proposed capital treatment for residual interests would, on a net-of-tax basis:

- Require that the amount of residual interests (aggregated with certain other types of assets) in excess of 25 percent of Tier 1 capital be deducted for regulatory capital purposes, and
- Require an institution to hold a dollar in risk-based capital for every dollar in residual interests (on a net of tax basis) up to the 25 percent limit.

The “dollar for dollar” capital requirement, in tandem with the concentration limit, would ensure that adequate risk-based capital is held against retained interests and would limit the amount of retained interests that can be recognized for regulatory capital purposes. Comments from interested parties generally considered the treatment to be very conservative and recommended that the agencies restructure the proposal to target those institutions whose retained interests posed undue risk to their banking operations. Since the comment period closed on December 26, 2000, the agencies have been working to ensure that we address our supervisory concerns while being mindful of the issues raised by commenters. The agencies expect to promulgate a final rule next month.

Additional Authority for the Insurer Under PCA may be Warranted

Prompt Corrective Action standards were intended to limit losses to the insurance funds. In some cases, the remaining capital cushion in troubled institutions will be sufficient to absorb as yet unrecognized losses. In other cases, the losses embedded in troubled institutions, i.e., losses which will be incurred as time passes due to the poor quality of some assets already on the books, may exceed the capital cushion.

Congress and the regulators face a difficult question in determining where the capital cut-off for various types of regulatory intervention should be. The tradeoff is between being careful not to seize an institution that truly possesses positive economic capital that might enable it to survive temporary financial problems, and waiting too long to act where an institution's actions may result in additional losses to the insurance funds. This trade-off is not always simple. For example, while the FDIC's study of the last banking crisis found that there were 343 banks that failed between 1980 and 1992 that might have been closed earlier under PCA, it also found that over the same time period there were 143 banks that did not fail that might have been closed under the PCA closure rule.⁵

Under PCA, the FDIC, as deposit insurer, only has authority to take separate action against non-FDIC supervised institutions that fall into the Critically Undercapitalized category. Among other things, such separate action could include restricting the institution's activities, reviewing material transactions, and approving

⁵ FDIC, *History of the Eighties—Lessons for the Future*, Vol. 1., p52.

capital plans. Institutions reach the Critically Undercapitalized level very soon before failure. Especially for institutions such as Superior, with highly volatile assets, limiting FDIC intervention to the Critically Undercapitalized level significantly inhibits our ability to direct remedial action that could minimize exposure to the funds. The FDIC believes that the deposit insurer should have additional authority under PCA rules before a non-FDIC-supervised institution becomes Critically Undercapitalized.

Regulatory Coordination Exists But Can Be Improved

The final lesson to be learned and perhaps the easiest one to resolve, is the need to improve regulatory coordination. While much discussion has focused on the supposed bureaucratic infighting between the OTS and the FDIC regarding Superior, the plain truth of the matter is that both agencies worked together for a period of well over eighteen months in dealing with this troubled institution. However, in this particular case, it may be valid to argue that having two sets of eyes earlier in the process may have mitigated the loss.

Section 10(b) of the Federal Deposit Insurance Act authorizes the FDIC to conduct an examination of any insured depository institution that is not directly supervised by the FDIC if the FDIC Board of Directors finds that an examination is necessary to determine the condition of the institution for insurance purposes. Over the years, the FDIC has adopted various policies to govern special insurance examinations. The current policy, adopted on March 5, 1995, delegates authority to the Director of the Division of Supervision or his written designee to approve special insurance examinations for banks where the FDIC has been invited to participate, and, in cases

where the primary Federal regulator does not object, for poorly rated (CAMELS 4 and 5) banks or banks likely to fail and for banks where material deteriorating conditions are not reflected in the current CAMELS rating. The Board must approve all other special insurance examination requests. As a result of bank and thrift failures over the past two years, the FDIC will review whether our own special insurance examination policy is inhibiting FDIC access to assess the risk that non-FDIC supervised institutions present to the insurance funds.

CONCLUSION

I appreciate the opportunity to appear before this Committee today to discuss the failure of Superior Bank and to again highlight the need for continued regulatory vigilance and more stringent accounting and capital standards for retained interest assets, particularly those related to subprime lending. I look forward to working with the Committee to see that these improvements are implemented.